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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 650

JOHN NICHOLAS, TRUSTEE OF THE ESTATE OF BEACHCOMBER MOTEL, INC., BANKRUPT,
Petitioner

v.

UNITED STATES OF AMERICA

On Writ of Certiorari to The United States Court of Appeals for the Fifth Circuit

---

REPLY BRIEF OF PETITIONER

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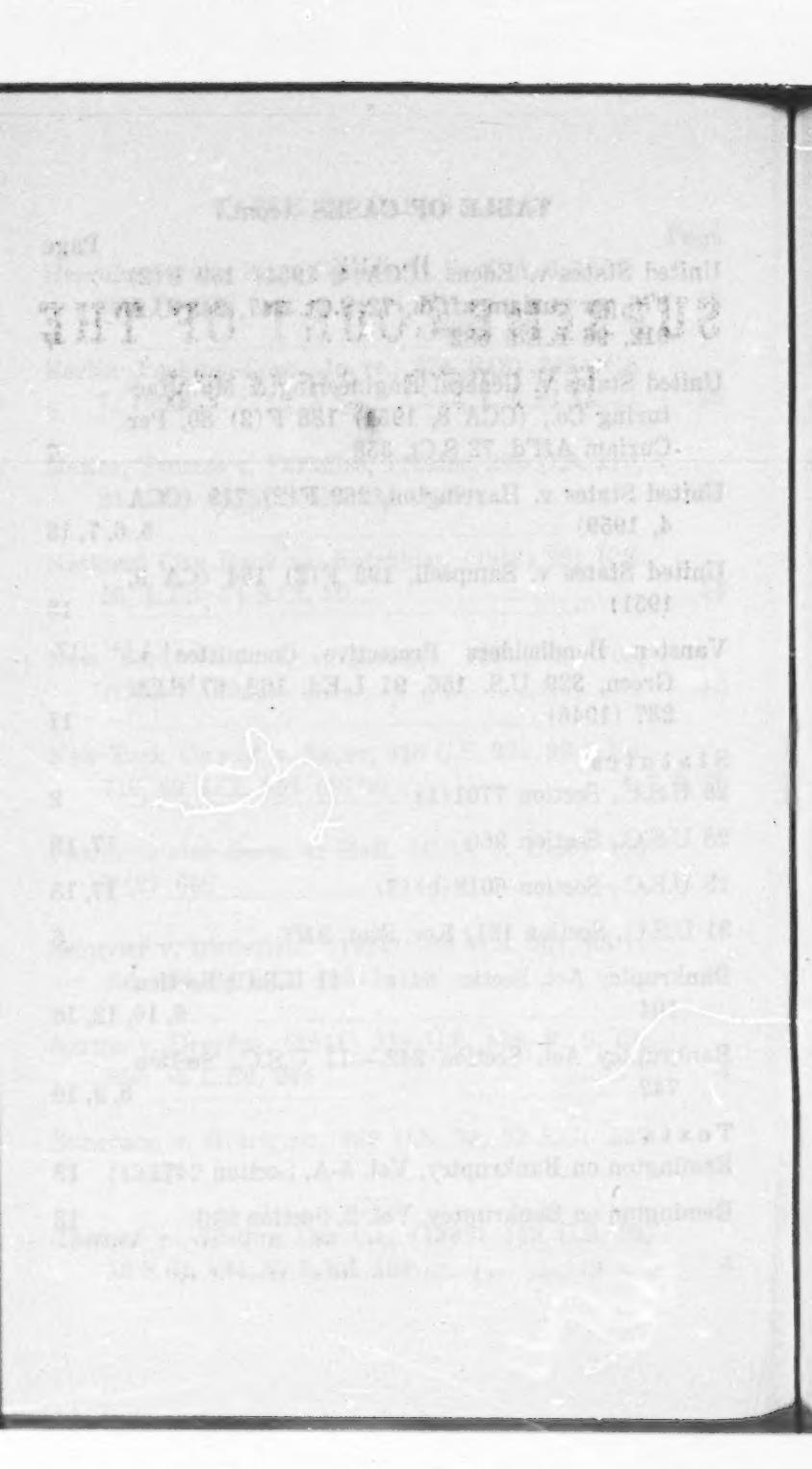

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REPLY BRIEF OF PETITIONER

INTRODUCTION

The sections in the Government's Brief entitled "Opinions Below" and "Jurisdiction" are correct.

STATUTES AND REGULATIONS

Statutes Involved:

In addition to the Statutes and Regulations cited to the Court in the Petitioner's Main Brief, and the Brief of the United States, 26 U.S.C., §7701 (1) of the Internal Revenue Code is pertinent:

> "Definitions
>
> (1) Person. — The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."

QUESTIONS PRESENTED

1. Whether the United States is entitled to recover from the assets of a bankruptcy estate, as part of a cost-of-administration claim, interest to date of payment on a claim for unpaid taxes incurred by a debtor-in-possession, while operating a business during the pendency of an arrangement proceeding under Chapter XI prior to adjudication.

2. Whether a trustee in bankruptcy is liable for penalties for failure to file tax returns for taxes when the taxes were the liabilities of a predecessor debtor-in-possession.

STATEMENT OF THE CASE

The statement of the facts in the brief of the United States is substantially correct, but requires some correc-

tion and clarification. When Beachcomber Motel, Inc. was adjudicated a bankrupt on September 17, 1958, the trustee appointed to liquidate the estate received no money, accounts receivable, or any tangible property, either real or personal, from the debtor in possession that had preceded him. (R. 17 and 18)

Therefore, the statements in the Government's brief to the effect that the trustee failed to pay taxes due on September 30, 1958, have little significance; the trustee had no resources from which to pay such taxes, even if it were proper for him to deviate from the priority prescriptions of the Bankruptcy Act.

The further contention by the Government that the trustee in bankruptcy should have filed a return on and paid on January 31, 1959, the F.U.T.A. taxes incurred by the debtor in possession, for the last quarter of 1958, infers to the Court that the trustee was responsible for the debtor's return and tax payment. It should be noted that none of the taxes at issue were incurred or collected by the trustee in bankruptcy; all accrued during the debtor in possession period, between August 6, 1958 and September 17, 1958. There is no specific statutory requirement that the trustee file the returns and pay the tax when due, as suggested by the Government in its statement of the facts.

The objections filed by the trustee to the Government's administrative expense claim objected to all penalties and post petition interest subsequent to the filing date of the original petition, on August 6, 1958.

The trustee was upheld by the Referee in Bank-

ruptcy (R. 12 and 13) and by the United States District Court on review by the United States (R. 14 and 15).

ARGUMENT

PART 1

THE GENERAL RULE IS THAT POST PETITION INTEREST ON TAX CLAIMS IN BANKRUPTCY IS NOT ALLOWABLE.

Petitioner's main brief demonstrated that the rule against allowance of post petition interest on tax claims is a long recognized, equitable rule, having its roots in over a century and a half of English bankruptcy practice which, as noted by Justice Holmes in **Sexton v. Dreyfus** (1911 219 U. S. 389, 31 S. Ct. 256, 55 L. Ed. 244, this nation accepted into its framework of law.

The development of the rule has been based on logical considerations and equitable principles that were memorialized in **City of New York v. Saper,** (1949) 336 U. S. 328, 69 S. Ct. 554, 93 L. Ed. 710, where the opinion by Mr. Justice Jackson recognized that the denial of post petition interest is in complete accord with the intent of Congress to assimilate "taxes to other debts for all purposes, including denial of post petition interest."

Since 1893, in **Thomas v. Western Car Company,** 149 U. S. 95, 13 S. Ct. 824, 37 L. Ed. 163, this court has recognized that after the property of an insolvent passes into the hands of a court officer, interest is not allowable on claims against the funds, and that delay in distribution of these funds occurs by act of law, as an incident to

settlement of the estate, and is not the fault of the court officer against whose estate the infliction of interest would fall. Since this time it has been well recognized in bankruptcy as well as other insolvency proceedings, that interest upon claims stops with initiation of proceedings.

In bankruptcy cases, the courts have been unanimous in holding that, generally, interest upon claims does not accrue after the filing of the petition, whether the claims are secured or unsecured. See **United States v. Harrington**, 269 F(2) 719, (CA 4, 1959) and cases there cited.

There have been two well established exceptions to this rule;

1. Where the bankrupt ultimately proves to be solvent

2. Where securities, held by the creditor, produce income after the filing of the petition. **United States v. Harrington, supra.**

Through the years, both secured creditors and the Government have sought to upset the statutory prescription of priorities, which form an integral and fixed part of the federal bankruptcy pattern, by seeking to carve out new judicial exceptions to the "no post petition interest" rule. The Courts, however, consistently have refused to recognize such new exceptions and have adhered to the express requirements of the Bankruptcy distribution statutes, as expressive of Congressional intent, as facilitative of practical administration of bankruptcy estates, and for equitable considerations, since to

grant such interest must be at the expense of other creditors entitled, by Statute, to dividend participation, possibly equal to that of the United States if the interest were denied.

Thus, in **United States v. Harrington**, supra, the Court of Appeals for the Fourth Circuit rejected another attempt to create a new exception, in favor of a Government claim for interest on its tax obligation, a claim was grounded on the argument that post bankruptcy interest is allowable to a secured creditor where the amount of the security is sufficient to satisfy both principal and interest on the secured claim and the Government if it holds a tax lien, is a secured creditor secured by all the property of the bankrupt and, since the sum total of all the bankrupt's assets could pay the principal of the Government claim plus interest, the other creditors of the estate would suffer, the Government was entitled to interest upon its tax claim until the date of payment, regardless of the punishing effect of such payment on other creditors, of equal or less priority.

In **Guaranty Title and Trust Company v. Title Guarantee & Surety Company**, 224 U. S. 152, 56 L. ed. 706, 32 S. Ct. 457 (1912) this Court refused to grant a super priority to the taxing authorities based on the then effective Revised Statute, Section 3466, 31 U.S.C. 191, which gave the United States priority on payment of tax cases in insolvency proceedings, holding that the Bankruptcy Act and its specification of priorities, controlled, in Bankruptcy proceedings.

In **Pacific States Corp. v. Hall** (CCA 9, 1948) 166

F(2) 668, the secured creditor insisted that another exception should be made to the no post petition interest rule in bankruptcy where the value of the security was in excess of the principal and interest. The court denied this interest.

Similarly, as is noted in **U.S. v. Harrington**, supra, though this court in **City of New York v. Saper**, supra, "intended to put the question to rest once and for all," the Government still continued to urge the courts to "confine the **Saper** case ruling to the specific situation existing in that case." (**U.S. v. Harrington**, at 721, citing **In Re Cameron**, (DC Sc. Cal. 1958), 156 F.Supp. 400

Thus, the Government sought, unsuccessfully, in **U.S. v. Edens**, (CCA 4, 1951) 189 F(2) 876, aff. 342 U.S. 912, 96 L.Ed. 682, 72 S. Ct. 357 to insulate Chapter X Reorganization proceedings from the ordinary bankruptcy rule of the **Saper** case, and in **U.S. v. Gen. Engineering & Mfg. Co.** (CA 8 1951) 188 F(2) 80, to avoid the application of the rule of the Saper case, in Chapter XI arrangement cases. Again, at **342 U.S. 912, 96 L.Ed.** 682, 72 S. Ct. 357 this Court, on the express authority of the **Saper** case, affirmed.

Various decisions have rebuffed the Government's effort to extend the doctrine to situations where Government's tax claims have been reduced to liens. These cases are collected in **U.S. v. Harrington**, supra.

The Government now seeks to create a new exception to the established "no post petition interest" rule of the **Saper, Edens** and **General Engineering** cases, contending that post petition interest should be granted

where the claim was incurred by a debtor in possession in an abortive debtor relief proceedings, where though there were no physical assets transferred to a succeeding trustee upon adjudication, this Trustee subsequently generated proceeds through liquidation of certain claims, sufficient (R 18) to pay a partial dividend on tax claims, Federal and local (R 5, 6).

The Government's position, as it sets out in its main brief, rests on, and requires acceptance of, three completely fictional concepts:

1. The concept that the debtor in possession and the succeeding trustee, elected upon adjudication, after displacement of the debtor in possession, have a common responsibility devolving from their common identity as "court officers". This fiction, considering antagonists as being responsible for each other's conduct, ignores the fact, well known to this court, that the debtor in possession and the trustee represent completely opposite vehicles, arrangement versus bankruptcy administration, of continued operation in arrangement proceedings versus liquidation upon rejection, by the creditors, of the proposed arrangement or other failure of the Debtor's Plan or operation. It is impossible to see why responsibility should be fixed upon the creditors' representative for the misconduct of the subject of the creditors' complaint in the arrangement proceedings, the operating debtor. There can be, between the debtor in possession and a trustee, only the most formal privity, and neither the trustee, himself, nor the creditors whom he represents, should respond, directly or indirectly, for the defalcations of a debtor in possession. While Section 342 of the Bankruptcy Act (11 U.S.C. 742, Resp. App. 29) vests the Debtor

in Possession with the powers of a trustee, no place in the Act is the Trustee charged with responsibility for the Debtor's misdeeds.

Our main brief has pointed out that it would be most inappropriate for a court of equity to indulge in a fiction to reach an unconscionable result, casting an inequitable burden upon other creditors, who must be deprived of a portion of their dividends in favor of one whose statutory priority has been prescribed by the Bankruptcy Act, as no higher than that of some of the sacrificing creditors.

2. The second fiction urged by the Government, at pages 15, 16 and 17 of its brief, and in its attempted distinction of the **Saper** case, from the facts at hand, is that the relevant decisions deal with tax claims of two priorities, accruing during two periods of time, i.e. pre-petition and post-petition, both with reference to the filing date of the proceedings; and that in numerous cases the courts award interest on post-petition taxes.

The fallacy of this assumption is that it ignores the existence of the 1952 amendment to §64(a) (1) of the Bankruptcy Act. (Government's Appendix 28) which, as set out in Petitioner's Main Brief, defines **three** periods of time with respect to the accrual of claims, the pre-petition period, the arrangement period, subsequent to the Petition but prior to adjudication, and the post-adjudication period. Each period has a specific assigned, different priority by Section 64(a) (1) of the Bankruptcy Act, supra.

In this connection, at page 10 of its Brief, the Gov-

ernment raises the spectre of the hypothetical lender, making a loan to a debtor in possession, necessary for continuation of its operations. The Government equates its position to this lender and assumes both would be paid all interest, in full. The Government fails to pursue this analogy fully, for such a creditor, lending to a debtor in possession, under a general order of authority, would discover in the event of subsequent adjudication, that his loan would be repayable only to the extent that it would participate, pro rata, with other arrangement administrative expenses, subordinate to and after full payment of liquidation expenses which are accorded a super priority by the 1952 amendment to §64(a) (1) of the Bankruptcy Act.

3. The third fiction urged by the Government to raise its exception urged to the "no post petition interest" rule is the doctrine of the fictitious trust fund. (Page 21, Argument C of the Government's Brief.) which shall be discussed in part two of this brief.

Recently, in Bruning v. U. S. 376 U. S. 358, 11 L.Ed. (2) 772, 84 S. Ct. 906 (1964) this Court acknowledged the essential soundness behind **New York v. Saper**. Mr. Chief Justice Warren stated at 376 U.S. 363 11 Ed. 2 775, 84 S.Ct. 908

> "The basic reasons for the rule denying post-petition interest as a claim against the bankruptcy estate are the avoidance of unfairness as between competing creditors and the avoidance of administrative inconvenience."

citing **American Iron & Steel Mfg. Co. v. Seaboard Air-**

line RR Co. 233 U. S. 261, 58 L.Ed 949, 34 S.Ct. 502 and, also, Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 91 L.Ed. 162, 67 S. Ct. 237 (1946).

Petitioner submits that the compelling argument for suspension of interest, in a bankruptcy, on pre-petition debts is equally forceful when applied to any pre-adjudication debts that accrued in a debtor relief proceeding. The nature of that proceeding suggests this result because income and activity have ceased and it is inequitable and impractical to prefer one class of creditors by arguing that the adjudication in bankruptcy is legally insignificant.

Boteler v. Ingels, 308 U. S. 57, 84 L. Ed. 78, 60 S. Ct. 29 (1939), imposed penalties on an operating trustee in bankruptcy for failure to pay State taxes that directly connected with his operation. Such an imposition on an operating trustee is logical, but certainly the reasons for the imposition is not analogous to the priority claims in a liquidating bankruptcy that follows an unsuccessful debtor relief proceeding.

The public policy of forcing the timely and early payment of taxes through the imposition of interest on the procrastinating taxpayer, whether he be an individual or an operating trustee, cannot be logically applied in the case of the liquidating trustee administering an estate such as Beachcomber Motel, Inc., Bankrupt.

The reasoning of this court in Simonson v. Granquist, 369 U. S. 38, 7 L. Ed. (2) 557, 82 S. Ct. 537 (1962) in the consideration of tax penalties in bankruptcy where the taxes had been perfected to a lien involved the same

logic with respect to interest. The court said: "tax penalties are incurred at least in part as punitive measures against persons who have been guilty of some defaults or wrongs. Enforcement of penalties against the estate of bankrupts, however, would serve not to punish the delinquent taxpayer, but rather their entirely innocent creditors."

It is not the trustee in bankruptcy who will suffer if he is required to pay claims prematurely or pay interest on payments which were deferred because the trustee did not have funds available for payment at the time the Internal Revenue Statutes would ordinarily require payment if a bankruptcy had not occurred. The creditors will bear the burden of the Government's interest imposition and if the liquidating administration does not have sufficient assets to pay all expense of administration claims in full, the Government will have gained an advantage on creditors of equal dignity under Section 64(a) of the Bankruptcy Act.

PART 2

TO CONTEND THAT SUMS OF MONEY WITHHELD AND COLLECTED AS TAXES, BY A DEBTOR IN POSSESSION, EVEN THOUGH EXPENDED AND UNTRACEABLE, CONSTITUTE A "TRUST FUND" TO CREATE A NOVEL, EXTRA-STATUTORY PRIORITY, IS UNREALISTIC, INEQUITABLE, AND UNWARRANTED.

The Government has recited to the Court various Court of Appeal cases in which the principal portion of

taxes collected in debtor relief proceedings were impressed with a trust in the hands of a superseding bankruptcy trustee. In no instance do the cases cited by the Government[1] support the exaction of interest on claims administered by the Bankruptcy Trustee; and, to the contrary it would appear that the reasoning of **In Re Kerber Packing Co.**, 276 F(2) 245 (CA 7, 1960); **U. S. v. Harrington, supra**, and **Simonson v. Granquist, supra**, is more appropriate, where interest and penalties were denied on taxes reduced to liens.

Parenthetically, reference to the Respondent's Proof of Claim (R-9) shows that the Government did not claim a trust fund, or the status of a secured creditor by reason thereof, in its Proof of Claim, did not assert any doctrine of trust, nor in any way assert a position as a beneficiary of the trust before the Referee in Bankruptcy. It is a position raised, de novo, on review or appeal, and, as such, we submit, is improper. **Fortson v. Dorsey**, 379 U. S. 433, 13 L. ed(2) 401, 85 S. Ct. 498 (1965).

We suggest that if a trust fund in fact existed, the Government should have been relegated to the summary process of the Bankruptcy turnover order (5-A **Remington on Bankruptcy**, Sec 2471, et seq.) and, further, that the filing of the claim by the Government without reference to any security claimed therefor constitutes a legal waiver of any security it may have had for its claim 2 **Remington on Bankruptcy** §980.

As has been noted above, there were no physical

[1]New York v. Rassner (CCA-2 1942) 127 F2 703; Hercules Service Parts Corp. v. U. S. (CA-6, 1963) 302 F2 938; U. S. v. Sampsell (CA-9 1959) 266 F2 631; Airline-Arista Printing Corp., (DCNY 1957) 156 F. Supp. 868.

assets transferred by the debtor-in-possession, Beachcomber Motel, Inc., to the liquidating trustee and apparently the same circumstances existed in the case of Seymour Wallis (Brief, amicus curiae, pg. 7).

We submit that the idea of creating a trust without a res on which it can be imposed is alien to both the law of trusts and the law of Bankruptcy. It is a fiction, without either a need or justification therefor.

Petitioner urges that this Court consider the well established rule that in order for a trust to exist there must be a fund or res in existence. **City of Dallas v. Crippen,** 171 F(2) 526 (CCA 5, 1949) stated the rule as follows:

> "If the bankrupt holds property in trust for another, the trustee in bankruptcy takes title to such property charged with the trust. So long as the property can be identified according to sound trust doctrine of tracing identification, it will be treated in bankruptcy as property to which creditors of the bankrupt have no claim, and will be paid over as a whole before disbursements are made to lien holders or unsecured creditors."

Considerable authorities supporting the rule that there must be a fund or a trust property in order for a trust to exist, find a basis in **National City Bank v. Hotchkiss,** 34 S. Ct. 20, 231 U.S. 50 in which Justice Holmes stated:

> "a trust cannot be established in alloquit share of a man's whole property, as distinguished from

> a particular fund, by showing that the trust moneys had gone into it. On similar principals a lien cannot be asserted upon a fund in a borrowers hands, which, at an earlier stage, might have been subject to it, if, by consent of the claimant, it had been a part of the borrowers general estate. But that was the result of the dealings between these parties, and it cannot be done away with by a wish or intention,..."

The **Hotchkiss** decision was followed by **Adams v. Champion**, (1935) 294 U.S. 231, 79 LEd 880, 55 S Ct. 399, in which Justice Cardozo restated the rule as follows:

> "They may be implements of justice in cases of theft or actual fraud. They may not be applied as to impose a trust by relation upon money that has entered into the 'stream of the firm's general property' and are distinguishable no longer."

The need for a res as a predicate for a trust in a bankruptcy situation was considered in **McKee, Trustee, v. Paradise, as Trustee**, 299 U. S. 119, 81 L. Ed. 75, 57 S. Ct. 129, (1936). Here, deductions made for the benefit of employees welfare association which were not deposited in a special account or "segregated" but were handled through bookkeeping entries, were contended by the association to constitute trust funds in the hands of the bankruptcy trustee. This Court, rejecting this argument stated:

> "The bankrupt was a debtor which had failed to pay its debt. We know of no principle upon

> which that failure can be treated as a conversion of property held in trust. At no time throughout the whole period was there a trust fund or res." (299 U.S., at 123)

Following the same principle is Schuyler, v. Littlefield, 232 U.S. 707, 58 L. Ed. 806, 34 S. Ct. 466 (1914). The court acknowledged that if identification of alleged trust funds is not clearly established by the evidence, that doubt must be resolved in favor of the Trustee in Bankruptcy.

The position of the Government that a trust should be imposed notwithstanding the absence of a res, is not only contrary to established doctrine but such a rule does considerable violence to the priority specifications of the Bankruptcy Act. Certainly the very existence of the costs of administration priority and its superior position under Sec. 64(a) of the Bankruptcy Act should carry with it, the implication that this is the only special privilege that should be granted to "costs of administration". No additional advantage should be accorded on either a trust or other fictional doctrine.

Adoption of a trust fiction necessarily invites a race by Governmental authorities to see which one can be the first to impress a trust outside and contrary to the provisions of Section 64(a) of the Bankruptcy Act. The Court should evaluate the claim of the Government within the framework of the Bankruptcy Act and decline to permit the imposition of a trust.

PART 3.

A TRUSTEE IN BANKRUPTCY SHOULD NOT INCUR STATUTORY PENALTIES FOR FAILURE TO FILE TAX RETURNS WHEN THE RETURNS WERE NOT HIS RESPONSIBILITY.

It is petitioner's contention that there is no obligation for a trustee in bankruptcy to file returns for the collections of withholding, F.I.C.A., F.U.T.A. and excise taxes when the taxes were not incurred during his administration.

The requirements of applicable statutes place the responsibility for filing returns as to such taxes on those persons who, in fact, made the collections.

There are no clearly defined statutory instructions placing this responsibility upon a trustee in bankruptcy and, therefore, to say that his failure to file a return is willful, is as prejudicial as it is meaningless.

There is only one statute requiring the filing of tax returns by a trustee in liquidating bankruptcy, and this statute does not apply to the taxes in question in the instant case, but relates only to income tax returns for corporations whose trustee has "possession or holds title to all or substantially all of the property of the business or corporation whether or not such property or business is being operated." 28 U.S.C., 6012(b)(3).

The Government suggests that 28 U.S.C., Section 960, which applies only to trustees "conducting a business"

would also apply to a liquidating trustee elected following an unsuccessful debtor relief proceeding. There is no basis for this suggestion.

We submit that Congress recognized a distinction between the trustee who conducts a business and the trustee that does not, in the above described section relating only to income taxes, 28 U.S.C., Section 6012 (b)(3), therefore, it follows that 28 U.S.C., Section 960 expressly relating only to a trustee conducting a business is inapplicable to the liquidating trustee, conducting no business and incurring no current tax liability.

There is, therefore, no express statutory duty on the non-operating trustee to carry out his predecessor debtor's statutorily prescribed reporting duties.

Both the Government and the decision of the Court of Appeals for the Fifth Circuit expressly rest upon **Boteler v. Ingels**, 308 U. S. 57, 84 L. Ed. 78, 60 S. Ct. 29 (1939), where this court upheld penalties against an operating trustee arising from his failure to pay license taxes incurred in favor of the State of California by the operation **by the Trustee** of motor vehicles on the highways of the State.

The reasoning of the Boteler case is inapplicable to the facts of the matter at hand. The trustee in Boteler was an operating trustee, rather than the non-operating liquidating trustee of Beachcomber Motel, Inc. whose major activities were the collection of the proceeds of litigation. The distinction between operating and liquidating trustees is well recognized; it was reiterated by the Court of Appeals for the Ninth Circuit on two occasions,

California Board of Equalization v. Goggin, 191 F(2) 726, (CCA 9, 1951)., 245 F(2) 44 (CA 9 1957)

Internal Revenue Statutes which require the return of collections for Withholding, FICA, FUTA and Excise taxes, place the responsibility for reporting on the persons collecting the revenue. The collector here was the debtor-in-possession or more specifically the managing officers of the Beachcomber Motel, Inc. and it was the responsibility of these officers to return to the government any collections of revenue and that responsibility continued notwithstanding the ensuing bankruptcy. Summarily, the Statutes do not require and it is inequitable to judicially prescribe, that the trustee assume the responsibility of making returns for revenue which he did not collect or even receive from the Debtor in Possession.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed and the District Court and the Referee in Bankruptcy affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, JOHN H. GUNN, Attorney for JOHN NICHOLAS, Trustee of the Estate of Beachcomber Motel, Inc., Bankrupt, Petitioner, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 15 day of April, 1966, I served copies of the foregoing REPLY BRIEF OF PETITIONER by mail, by depositing the same in a United States mail box, with first class postage prepaid, addressed to counsel of record at their post office addresses, as follows:

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